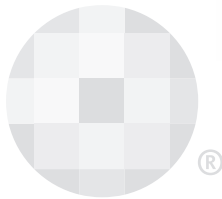


State Law & State Taxation Corner

By *Thomas E. Rutledge*

The Statute of Frauds and Partnership/Operating Agreements



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In a recent decision, *Olson v. Halvorsen*,¹ the Delaware Supreme Court addressed whether the Statute of Frauds, as it relates to agreements that are not susceptible to performance within one year, is applicable to LLC operating agreements. In this instance, and as a matter of law, the Delaware Chancery Court held that the Statute of Frauds does apply to those aspects of an oral operating agreement that are not susceptible to performance within a single year.

***Olson v. Halvorsen* and Its Facts**

Olsen, Halvorsen and Ott formed a series of companies for the purpose of operating a pair of hedge funds, Viking Global Equities LP and Viking Global Equities III Ltd., focused on, respectively, on-shore and off-shore opportunities. Viking Global Founders LLC (“Founders”), whose relationship with the two hedge fund limited partnerships is never made express in the opinion, had as members Olsen, Halvorsen and Ott. The draft operating agreement of Founders, which agreement was never signed, contained an earn-out provision entitling a departing partner to an earn-out over six years. For several of the other related companies, written operating agreements were executed and put in place.

In 2005, Halvorsen and Ott, with Halvorsen representing a 55-percent interest and Ott a 22.5-percent interest, determined to expel Olsen from the business. Consequent to that determination, they paid to Olsen his capital account balance and the remainder of his 2005 salary. In response to Olsen’s demand for payments under the earn-out as set forth in the unexecuted operating agreement, Halvorsen and Ott



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asserted that it did not constitute part of their agreement. In response, Olsen filed suit seeking to collect on the six annual pay-outs. Considering cross-motions for summary judgment, the court requested additional authorities for the position that the Statute of Frauds would apply to an oral operating agreement, and in response thereto the court was advised of secondary sources on the point, but no direct case law.

Ultimately granting the defendant's motion for summary judgment as to the assertion that the failure to make the six-year pay-out constituted a breach of contract, the Chancery Court (Vice Chancellor Lamb) held that Statute of Frauds does apply to oral operating agreements and, further, that the exceptions argued by the plaintiff were not applicable.

The Delaware LLC Act provides that a limited liability company agreement² may be "written, oral or implied."³ In light of the express authorization of an oral agreement, the Chancery Court considered whether the Statute of Frauds should apply to those agreements. The Delaware Statute of Frauds provides that an agreement "that is not to be performed within the space of one year from the making thereof" must be in writing and signed by the party against whom enforcement is sought.⁴ In stating that an operating agreement may be oral or implied, the Delaware LLC Act is not express as to whether or not the Statute of Frauds applies. After observing a conflict between commentators,⁵ the Court determined that there was no broad exemption of operating agreements from the Statute of Frauds, and that to the extent that a nonwritten agreement might contain a provision that cannot possibly be performed within one year, the agreement to that extent will not be enforceable.⁶ From there, the Court went on to determine that the six-year payout sought by Olson was not subject to performance within a year and that it did not fall within any of the exceptions, specifically multiple writings and past performance, that would exempt it from the Statute of Frauds. Consequently, Olsen did not receive the six-year pay-out he sought.⁷

Other Acts

It is quite common for LLC and Partnership Acts expressly to recognize oral and implied agreements.⁸ Under the Indiana Business Flexibility Act, an "operating agreement" is defined as referring to "any written or oral agreement of the members as to the affairs of a [LLC] and the conduct of its business that is binding upon all the members."⁹ The Revised

Uniform Limited Liability Company Act (2006) recognizes that an "operating agreement" may be "oral, in a record, implied, or in any combination thereof."¹⁰ Virginia, in defining an operating agreement, simply refers to "an agreement of the members," without specifying whether the agreement must be in writing or otherwise.¹¹ Similarly, partnership agreements may be written, oral or implied,¹² as may limited partnership agreements.¹³

In contrast, the New York LLC Act defines an operating agreement as a "written agreement" of the members.¹⁴ Further, the New York LLC Act, in §417, directs that the members "shall adopt a written operating agreement," but states nothing further with respect to whether the failure to do so either impacts upon the validity of the LLC or the enforceability of an operating agreement that is not in writing. At least one New York court has held that the default provisions of the New York LLC Act constitute the "statutory operating agreement" of the LLC.¹⁵

The Revised Uniform Limited Liability Company Act¹⁶ does not impose any Statute of Frauds limitations within its text, while the Prototype LLC Act did impose writing requirements with respect to several distinct points, including capital contribution obligations, mandatory records and assignment of an interest in the LLC.¹⁷ Conversely, the Kentucky LLC Act has distributed throughout the limitation, *inter alia*, "except as provided in a written operating agreement."¹⁸ The best reading of these provisions is that they are point specific Statute of Frauds that neither (a) suggest that the general Statute of Frauds is not applicable to the agreement as a whole nor (b) in any manner imply that a provision not so initiated is not subject to modification in the operating agreement. For example, the Kentucky LLC Act, at KRS 275.290(1), details the basis upon which an LLC may be judicially dissolved; the provision does not contain an "except as otherwise provided in a written operating agreement" provision. Rather than implying that the provision is for that reason not subject to modification or waiver by private ordering,¹⁹ the correct reading is that there simply exists no Statute of Frauds limitation, at least with the LLC act, as to such a modification or waiver.

Other Aspects of the Statute of Frauds

The Statute of Frauds addresses, of course, obligations other than those to be performed in a single

year. For example, it is common and indeed may be universal that agreement relating to the sale or transfer of real property must be in writing.²⁰ An obligation to contribute real property to a partnership or LLC is clearly subject to the Statute of Frauds.²¹ Conversely, the fact that the sole or the primary asset of an LLC is real property does not of itself subject the operating agreement to the requirements of the Statute of Frauds.²² Further, it has long been recognized that an oral partnership agreement addressing the profits from or dealing in real property for profit is not invalid on the grounds of the Statute of Frauds.²³

The Partnership Cases

With respect to general partnerships, the application of the Statute of Frauds may depend on the nature of the partnership. Partnerships may exist “at will,” “for particular undertaking” or “for a particular term.”²⁴ With respect to a partnership at will, that being one which is terminable by any partner without, absent contrary private ordering, any liability consequent to that termination, the agreement to establish the partnership is terminable within one year of its making and is therefore outside the Statute of Frauds.²⁵ Conversely, where a partnership is for a term to exceed a year, or where the undertaking will require more than a year from the time of the making of the contract, and there is agreement to remain partners for that period of time, the agreement should be subject to the dictates of the Statute of Frauds.²⁶ Unfortunately, it must be recognized that not all courts have recognized these distinctions, and have as a consequence issued overly broad and consequently incorrect statements as to the application (or not) of the Statute of Frauds.²⁷

The Application of the Statute of Frauds to Oral Partnership/Operating Agreements

At a recent meeting of the Committee on LLCs, Partnerships and Unincorporated Entities, there was a split among the participants regarding the impact of the *Olsen* ruling. There was expressed the view that the decision is detrimental to the enforcement of agreements and that the statutory authorization of oral and implied agreements should have been interpreted as overriding the Statute of Frauds. Other participants took the opposite view, noting that there was no express override of the Statute of Frauds,

that the Delaware legislature is well aware of how to expressly override otherwise applicable statutory provisions,²⁸ and that partnership/operating agreements are not of such a nature that the accepted benefits of the Statute of Frauds should not there apply. I am of the second opinion. The Statute of Frauds applies not to agreements generally, but only (at least as applied in Delaware) to individual provisions of agreements that have not been reduced to a signed writing. *Olsen* has no application to signed agreements, but the knowledge of its holding should further incentivize both counsel and members to see that the partnership/operating agreements that are prepared are properly executed. Terms that do not implicate one of the categories of agreements subject to the Statute of Frauds, including terms that are subject to performance within a year, will remain enforceable. Only a narrow class of possible terms will be set aside by the Statute of Frauds, and the fact that it has taken until 2008, Delaware having adopted its LLC Act in 1992, for such a case to arise evidences that the issue is quite narrow.

That said, there is at least one point on which clarification would be helpful. Under Delaware law, as well as the law of numerous other jurisdictions, a merger or other organic transaction may be approved by less than a majority of the partners/members,²⁹ but even those not voting in favor of the transaction are deemed bound by the partnership/operating agreement of the organization surviving the transaction.³⁰ There is a question as to whether the nonconsenting partners/members are going to be able to assert a Statute of Frauds defense against any provisions of those agreements that fall within the Statute of Frauds. While there will in most if not all instances be no question as to the terms of the agreement, the, or at least a, question will be whether the statutory declaration that the partners/members are bound is sufficient to override any provisions thereof that would otherwise implicate the Statute of Frauds.

Conclusion

Partnerships, both limited and general, and LLCs exist not as islands of law unto themselves but rather within a sea of other law.³¹ Being primarily creatures of private ordering between the participants, we are accustomed to looking first to that agreement in order to ascertain the rights and responsibilities of the various parties.³² The *Olsen* decision provides important guidance as to how broader contract law applies in

the relatively new realm of operating agreements, and cautions each of us who have relied upon an express statutory authorization/recognition of oral

operating agreements not to consider such to be *ipso facto* exempt from broader contract law including the Statute of Frauds.

ENDNOTES

¹ *Olson v. Halvorsen*, Del. Ch., 2008 Del. Ch. LEXIS 156 (Oct. 22, 2008).

² While “limited liability company agreement” is the defined term in the Delaware LLC Act (DEL. CODE ANN. tit. 6, §18-101(7)), throughout the opinion these documents are referred to as “operating agreements.”

³ DEL. CODE ANN. tit. 6, §18-101(7) provides in full: “‘Limited liability company agreement’ means any agreement (whether referred to as a limited liability company agreement, operating agreement or otherwise), written, oral or implied, of the member or members as to the affairs of a limited liability company and the conduct of its business.”

⁴ DEL. CODE ANN. tit. 6, §2714(a). Other states have similar rules. For example, the Kentucky Statute of Frauds provides in part that “No action shall be brought to charge any person: ... (7) Upon any agreement that is not to be performed within one year from the making thereof.” KY. REV. STAT. ANN. §371.010.

⁵ The court recited the observation of Professors Bishop and Kleinberger to the effect that while the definition of an operating agreement may encompass oral agreements, nothing therein would suggest an attempt to override the Statute of Frauds (CARTER G. BISHOP & DANIEL S. KLEINBERGER, LIMITED LIABILITY COMPANIES: TAX AND BUSINESS LAW §14.03 (2008), and Symonds and O’Toole for the proposition that statutory recognition of oral operating agreements, when combined with the stated policy to give maximum effect to the enforceability of operating agreements (DEL. CODE ANN. tit. 6, §18-1101(b)), creates an inference that the Statute of Frauds should be overridden. ROBERT L. SYMONDS, JR. & MATTHEW J. O’TOOLE, SYMONDS & O’TOOLE ON DELAWARE LIMITED LIABILITY COMPANIES §4.02 (2007).

⁶ It should be recognized that this provision-by-provision application of the Statute of Frauds is at odds with the rule as sometimes applied that if any aspect of the agreement falls within but does not satisfy the Statute of Frauds, the entire agreement is unenforceable. See, e.g., E. ALLAN FARNSWORTH, CONTRACTS §6.4 (2nd Ed. Little Brown 1990).

⁷ In *Sheehy v. Clifford Chance Rogers & Wells LLP*, NY CtApp, 3 NY3d 554, 822 NE2d 763, 789 NYS2d 456 (2004) the court held that a claimed agreement to pay certain retirement benefits to a departing partner notwithstanding the fact that, under the partnership agreement as written he did not qualify for same, was subject to the Statute of Frauds and for that reason not enforceable.

⁸ See, e.g., KY. REV. STAT. ANN. §275.015(20) (“‘Operating agreement’ means an agreement, written or oral, among all of the members, as to the conduct of the business and affairs of a [LLC].”)

⁹ IND. CODE §23-18-1-16.

¹⁰ ULLCA §102(13), 6B U.L.A. 429 (2008).

¹¹ VA. CODE ANN. §13.1-1002. See also SOUTH CAROLINA CODE §33-44-101(13) (defining operating agreement as an agreement but not specifying whether or not such may need be in writing, exist orally or be implied). See also 1 LARRY E. RIBSTEIN AND ROBERT R. KEATINGE, RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES, appendix 4-19 (Thomson/West 2007).

¹² See, e.g., Revised Uniform Partnership Act §101(7), 6 U.L.A. 61; KY. REV. STAT. ANN. §362.1-101(11).

¹³ See, e.g., Uniform Limited Partnership Act (2001) §102(13), 6A U.L.A. 359 (2008); KY. REV. STAT. ANN. §362.2-102(17).

¹⁴ New York LLC Law §102(u).

¹⁵ See *In re Spires*, N.Y. SCT., 4 Misc. 3d 428; 778 NYS2d 259; 2004 N.Y. Misc. LEXIS 628 (2004)

¹⁶ 6B U.L.A. 407 (2008) (hereinafter “RUL-LCA”).

¹⁷ See Prototype LLC Act §405 (mandatory records), §502 (capital contributions) and §704 (assignment).

¹⁸ See, e.g., KY. REV. STAT. ANN. §275.150(2) (waiver of limited liability as to all or certain debts of the LLC), §275.220 (member not entitled to a distribution other than in cash), and §275.265 (admission of an assignee as a member).

¹⁹ See *R&R Capital, LLC v. Buck & Doe Run Valley Farms, LLC*, Del. Ch., 2008 Del. Ch. LEXIS 115 (Aug. 19, 2008).

²⁰ See, e.g., KY. REV. STAT. ANN. §371.010 (“No action shall be brought to charge any person: ... (6) Upon any contract for the sale of real estate”)

²¹ See, e.g., *Deshazo v. Estate of Clayton*, DC Id., 2006 U.S. Dist. LEXIS 44612 (2006) (oral promise by a member to contribute real property to LLC unenforceable under Statute of Frauds); *Quimby v. Myers*, SCT, 179 Vt. 611, 895 A2d 128 (2005) (“It is well settled that a writing is required to transfer real property, already owned by one partner, to another partner or to the partnership,” citing in support thereof *Johnson v. Gilbert*, Az. CtApp, 127 Ariz. 410, 621 P.2d 916 (1980) (contract providing for “transfer of land from one partner or joint venturer to another is within the Statute of Frauds”); *McCloud v. Davison*, Fla. CtApp, 719 So2d 995 (1998) (agreements between partners

or joint venturers to buy or sell land are not within the purview of the Statute of Frauds “unless there is a provision for transfer of title to specific real property from one of the parties to another”); *Amendola v. Kendzia*, N.Y. SCT, 17 AD3d 1105, 793 NYS2d 811 (2005) (affirming motion to dismiss partner’s claim for accounting of alleged partnership asset in real property on ground that oral agreement to convey property to partnership was barred by Statute of Frauds); *Ludwig v. Walter*, N.C. CtApp, 75 NC App. 584; 331 SE2d 177 (1985) (“[T]he general rule is that land owned individually by one who enters into a partnership cannot become a partnership asset absent some written agreement sufficient to satisfy the Statute of Frauds.”); *Gunsorek v. Heartland Bank*, Ohio CtApp, 124 Ohio App. 3d 735, 707 NE2d 557, 563-64 (1997) (trial court erred in failing to grant summary judgment based on absence of writing under general rule that partner’s agreement to transfer real property he already owned as his contribution to the partnership is within Statute of Frauds); *Shire Dev. v. Frontier Invs.*, Utah CtApp, 799 P2d 221, 223-24 (1990) (if agreement provides for transfer of real property interests among partners, “it would have to be in writing in order to comply with the Statute of Frauds”); see generally 1 Z. CAVITCH, BUSINESS ORGANIZATIONS §14.03[2], at 14-15 (2005) (observing that Statute of Frauds applies “where real property [is] to be conveyed from one partner to another”); 9 R. LORD, WILLISTON ON CONTRACTS, §25.17, at 606 (4th ed. 1999) (noting general rule that agreement that new partnership shall have an interest in realty owned by one of the partners is within the Statute of Frauds).

²² See, e.g., *Fausak’s Tire Center, Inc., v. Blanchard*, Ala. Civ.App., 959 So2d 1132 (2006) (an oral buy-sell agreement as to an interest in an LLC was not unenforceable by reason of the Statute of Frauds even though the LLC’s sole asset was real property; the interest subject to the buy-sell agreement was personal property).

²³ See, e.g., 1 WILLIAM F. ELLIOTT, COMMENTARIES ON THE LAW OF CONTRACTS at §488, p. 725 (Bobbs-Merrill 1913).

²⁴ See Revised Uniform Partnership Act §101(8), 6 U.L.A. 61 (defining a “partnership at will”); KY. REV. STAT. ANN. §362.1-101(12) (*id.*); Official Comment to RUPA §101.

²⁵ See, e.g., *Abbott v. Hurst*, Ala. SCT, 643 So2d 589 (1994). As to the rule that no damages arise on the dissolution of a partnership at will, see generally 59A AM.JUR.2d *Partner-*

ENDNOTES

ship §565.

- ²⁶ See, e.g., CALLISON & SULLIVAN, PARTNERSHIP LAW AND PRACTICE §5:32 (“An agreement to form a partnership for more than one year is within the Statute of Frauds, and when there is no written agreement, the partnership arrangement can be dissolved without breach of contract at any time prior to part performance of the contract.”). See generally 1 ALAN R. BROMBERG AND LARRY E. RIBSTEIN, BOMBERG AND RIBSTEIN ON PARTNERSHIP §2.13(c).
- ²⁷ See, e.g., *Estate of Delbert Bessinger v. Kirkwood*, Nos. 1997-CA-000534-MR and 1997-CA-000610-MR (Ky. App. December 30, 1998) (“It is clear that partnership agreements do not fall within the Statute of Frauds, KRS 371.010.”), citing *Frankfort & Cincinnati Railway Co. v. Jackson*, Ky. CtApp, 153 Ky. 534, 156 SW 103 (1913), *Goodwin v. Smith*, Ky. CtApp, 144 Ky. 41, 137 S.W. 789 (1911).
- ²⁸ An example given was the override of UCC §9-406 and §9-408 that appears at DEL.

CODE ANN. tit. 6, §§18-1101(e), 15-104(c) and 17-1101(e).

- ²⁹ DEL CODE ANN. tit. 6, §18-209(b) (approval of LLC merger by 50 percent of voting units) See also KY. REV. STAT. ANN. §275.350(1) (approval of merger by majority-in-interest of the members); Utah Code Ann. §§48-2c-1408(1)(a), 48-2c-803(3)(ii)(f) (approval of merger by members holding two-thirds of profits interests); and TENN CODE ANN. §48-249-702(c)(B)(approval of merger by majority of the members).
- ³⁰ DEL CODE ANN. tit. 6, §18-209(f)(1)-(2) (providing for amendment or adoption of operating agreement of LLC surviving merger). See also KY. REV. STAT. ANN. §275.360(4) (a plan of merger may provide for the amendment or creation of an operating agreement to “be effective at the effective time or date of the merger.”); TENN. CODE ANN. §48-249-702(i) (amendment of existing or adoption of new operating agreement by merger)
- ³¹ See, e.g., Uniform Partnership Act §4, 6 U.L.A. 386 (2001); RUPA §104(a), 6 U.P.A.

78 (2001); RULLCA §107, 6B U.L.A. 440 (2008); KY. REV. STAT. ANN. §275.003 (“Unless displaced by particular provisions of this chapter, the principles of law and equity shall supplement this chapter.”)

- ³² See, e.g., *Fisk Ventures, LLC v. Segal*, Del. Ch., 2008 Del. Ch. LEXIS 158 (May 7, 2008) (the operating agreement “defines the scope, structure, and personality of limited liability companies”); *TravelCenters of A.M., LLC v. Brog*, 2008 WL 1746987 at *1 (Del. Ch. April 3, 2008) (“Limited Liability Companies are creatures of contract, ‘designed to afford the maximum amount of freedom of contract, private ordering and flexibility to the parties involved.’”) (quoting in part *In re Grupo Dos Chiles, LLC*, Del. Ch., 2006 Del. Ch. LEXIS 54 (Mar. 10, 2006); *Walker v. Resource Development Company Limited, LLC*, Del. Ch., 791 A2d 799 (2000) (“LLC members’ rights begin with and typically end with the Operating Agreement.”); DEL. CODE ANN. tit. 6, §18-1101(b); KY. REV. STAT. ANN. §275.003.

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